Akin Gump
Strauss Hauer & Feld LLP

Corporate and International Trade Alert

SEC Adopts Final Rule for Disclosure of Payments to Governments by Resource Extraction Issuers

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On August 22, 2012, the U.S. Securities and Exchange Commission (SEC) adopted a final rule requiring reporting companies to make annual disclosures on the new Form SD, which details payments that they, or any entities subject to their control, have made to the U.S. federal government or to non-U.S. governments for the purpose of the commercial development of oil, natural gas or minerals.

Companies subject to new Rule 13q-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), must begin complying with the rule for fiscal years ending after September 30, 2013, with a Form SD due no later than 150 days after the end of the company's most recent fiscal year. If a company's fiscal year begins on or before September 30, 2013, the company may file a partial report for the period from October 1, 2013 through the end of its fiscal year. The Form SD is required to be filed with the SEC on EDGAR, and the information required by Form SD must be presented in XBRL format as an exhibit to the form.

Rule 13q-1 under the Exchange Act implements a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act aimed at increasing the transparency of payments made to governments of resource-rich countries and, as U.S. Sen. Richard Lugar stated, "help empower citizens to hold their governments [accountable] for the decisions made…in the management of valuable oil, gas, and mineral resources and revenues." The provision supports the federal government's commitment to the Extractive Industries Transparency Initiative, a coalition of governments and nongovernmental organizations seeking to increase resource extraction transparency through the adoption of reporting schemes.

CHANGES TO THE PROPOSED RULE

In the final rule, the SEC made several key modifications to its original proposal, which was released in December 2010. (See Akin Gump alert on proposed rules here.) These key modifications include the following:

- An issuer must file with the SEC the information required by the final rule in a separate Form SD, rather than furnish the information in its annual report. Because the information is required to be filed, rather than furnished, issuers will be subject to Exchange Act Section 18 liability for any false or misleading statements included in the form unless the issuer can establish that it acted in good faith and did not have knowledge that the statement was false or misleading. The disclosures, however, will not be subject to the CEO and CFO certifications required under the Exchange Act. The information in the Form SD will not be deemed incorporated by reference into other SEC filings.

- The concept of de minimis is now defined and only payments equal to or greater than $100,000 are required to be reported.

- The issuer must disclose two additional categories of payments—dividends and infrastructure improvements—and report not only cash, but also in-kind payments.

- A new anti-evasion provision requires the disclosure of any payment characterized outside the bounds of the rule as part of a plan or scheme to evade Section 13(q).

KEY TERMS AND PROVISIONS OF THE FINAL RULE

As adopted, a company is subject to this new reporting requirement if it qualifies as a "resource extraction issuer" and if it, or any subsidiary or other entity under its control, makes "payment[s]" to "governments." While the adopting release attempts to clarify which companies are subject to the rule by providing examples and descriptions, the following key questions remain unresolved:

- ***"Resource Extraction Issuer."*** The final rule applies to any "resource extraction issuer," defined as "an issuer that: (i) is required to file an annual report with the [SEC]; and (ii) engages in the commercial development of oil, natural gas, or minerals."[1] This definition encompasses both U.S. and foreign issuers filing annual reports (e.g., 10-K, 20-F or 40-F), regardless of their size or the extent of their resource extraction commercial development operations.[2] The final rule also applies to government-owned companies. Payments made by a subsidiary of the issuer or an entity under the issuer's control must also be disclosed. The adopting release notes that an issuer's joint venture with, or private equity investment in, an entity involved in resource extraction, if the entity is under the issuer's control, may also trigger the disclosure requirement.

- ***"Commercial Development of Oil, Natural Gas, or Minerals."*** The final rule defines "commercial development of oil, natural gas, or minerals" to include the activities of "exploration, extraction, processing, and export of oil, natural gas, or minerals, or the acquisition of a license for any such activity," and indicates that this list is exhaustive.[3] Commercial development constitutes only directly related activities—an oil extractor would fall within the definition, but a manufacturer of drill bits used to extract oil would not. The adopting release specifies what sub-activities the terms "extraction," "processing," and "export" include, as follows, although it does not absolutely define the parameters of these activities.

  - **Extraction**: includes the production of oil and natural gas and the extraction of minerals.

  - **Processing**: includes field processing activities (e.g., removing impurities from natural gas prior to pipeline transport or upgrading of heavy oil) and the crushing or processing of raw ore, but does **not** include smelting or refining.

  - **Exporting**: includes transport of the resources from the host country, but does **not** include transport of the resources from extraction to a refinery or smelter, or to underground storage prior to export.

- ***"Payment."*** The issuer must disclose any payment that (i) is made to further the commercial development of oil, natural gas or minerals; (ii) is not de minimis; and (iii) falls within these payment types:

  - taxes, including taxes on corporate profits, corporate income and production, but not taxes levied on consumption, such as value added taxes, personal income taxes or sales taxes

[1] 17 CFR § 240.13q-1(b)(1).
[2] A foreign private issuer that is exempt from the registration and reporting requirements of the Exchange Act will not be subject to the new rule because it is not required to file an annual report with the SEC.
[3] 17 CFR § 240.13q-1(b)(2). Both the final rule's lack of nondelimiting language (for example "including, but not limited to,") and a statement in the adopting release notes that "the statutory language sets forth a clear list of activities…and we are not persuaded that we should extend the rules to activities beyond the statutory list" indicate that the list provided was intended to be exhaustive.

  - royalties
  - fees, including rental fees, entry fees and concession fees
  - production entitlements
  - bonuses, including signature, discovery and production bonuses
  - dividends, other than dividends paid to a government as a common or ordinary shareholder of the issuer on the same terms as other shareholders
  - payments for infrastructure improvements, such as a road or railway to access resources for extraction, but not including social or community payments, such as payments to build a school or hospital.

- As previously noted, the final rule made two significant changes: (i) it requires disclosure of in-kind payments of the nature described above and (ii) it added a de minimis exception. A payment is not de minimis if it equals or exceeds $100,000 as a single payment or series of related payments during the most recent final year.

- ***"Governments."*** Payments made to governments include payments made to the U.S. federal government, foreign governments, foreign subnational governments (such as state, provincial and municipal governments, but not including state or local governments in the United States), instrumentalities of foreign governments and companies at least majority-owned by foreign governments. The commentary indicates that the rule also covers payments made to governments by third parties on the issuer's behalf.

- ***No exemptions provided for disclosure requirement.*** Despite comments calling for various exemptions, such as when disclosure of payments would violate a host country's laws or a contractual confidentiality clause, the final rule does not provide for any exemptions from the disclosure requirements.

DISCLOSURE REQUIREMENTS

Issuers must disclose specified information about each qualifying payment, including the type and total amount of payments made for each "project." Although many commentators favored defining the term "project," and the SEC considered defining "project" at a country level, as a reporting unit, in relation to a particular geologic resource or by reference to a materiality standard, it ultimately determined that leaving the term open for interpretation granted issuers greater flexibility when reporting the required information. Notwithstanding its intention to provide issuers with flexibility, the SEC's decision not to define "project" is likely to result in uncertainty as to the disclosure requirements of the final rule and may result in inconsistent reporting, with companies characterizing projects, and therefore payments, along a broad spectrum.

The final rule requires an issuer to disclose the following information on the Form SD filed with the SEC:

- the type and total amount of payments made for each project
- the type and total amount of payments made to each government
- the total amount of payments, listed by the payment-type categories
- the currency used to make the payments
- the financial period in which the payments were made

- the business segment of the issuer that made the payments
- the government that received the payments and its country location
- the project to which the payments relate.

COMPLIANCE CHALLENGES

Issuers are already required under the Foreign Corrupt Practices Act (FCPA) to have in place internal accounting controls designed to ensure that any payments to foreign officials are accurately reflected in an issuer's books and records and vetted for compliance with that act. Rule 13q-1, however, will require disclosure of many other types of payments, such as dividends, payments through private equity investments and production entitlements, that companies may not track through previously adopted FCPA compliance procedures. Companies will be required to develop systems designed to capture this information for reporting purposes; significant time and resources will need to be dedicated to this effort.

In addition, companies should also be aware of the rule's potential impact on existing and future contracting arrangements. As noted, the rule does not provide for any exemptions from the reporting obligation due to foreign law or due to contractual restrictions on the disclosure of business information, such as payments. Therefore, when negotiating agreements, companies will need to ensure that any agreements under which payments will be made contain terms that will allow for the kind of reporting necessary, so they may comply with the rule's requirements

CONTACT INFORMATION

If you have any questions concerning this alert, please contact—

Rick L. Burdick
rburdick@akingump.com
202.887.4110
Washington, D.C.

Daniel I. Fisher
dfisher@akingump.com
202.887.4121
Washington, D.C

Paul E. Gutermann
pgutermann@akingump.com
202.887.4088
Washington, D.C.

Lars-Erik A. Hjelm
lhjelm@akingump.com
202.887.4175
Washington, D.C.

Christine B. LaFollette
clafollette@akingump.com
713.220.5896
Houston

Wynn H. Segall
wsegall@akingump.com
202.887.4573
Washington, D.C.

Jeffrey B. Werbitt
jwerbitt@akingump.com
202.887.4173
Washington, D.C.

Christopher T. Timura
ctimura@akingump.com
202.887.4597
Washington, D.C.

Emily S. Fuller
efuller@akingump.com
202.887.4057
Washington, D.C.

Casey K. Richter
crichter@akingump.com
202.887.4114
Washington, D.C.